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TAXATION

OVERVIEW

The Tenth Circuit Court of Appeals reviewed over thirty cases in the area of taxation during the past year. Many of these were tax "protester" cases that involved specious defenses and as such, will not be reviewed here. Of the remaining cases, few broke new ground in the field of tax law. Several cases did highlight splits among the circuits, showing the need for Supreme Court review or congressional clarification.

I. ENFORCEMENT OF CIVIL SUMMONS

A. *Background*

The Secretary[1] is empowered, under section 7602 of the Internal Revenue Code, to examine any books, papers, records,[2] or other data necessary to audit a taxpayer's return, and to summon the taxpayer or any person having possession of such books, papers, records, or data to appear before the Secretary to give testimony or to produce the documents. This authorization is limited to the purposes of:

> [A]scertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability . . . .[3]

Noticeably absent from the list of authorized purposes is that of obtaining information for a criminal prosecution or investigation. The possible constitutional problems that would be associated with such an authorization are obvious. Nonetheless, "[t]he legislative history of the Code supports the conclusion that Congress intended to design a system with interrelated criminal and civil elements,"[4] and Congress as well as the courts have attempted to draw the line that separates the permissible from the impermissible use by the Internal Revenue Service (IRS or Service) of its summons authority.

In those cases in which a summons is issued under the authority of section 7602 and directed at a third-party recordkeeper,[5] the taxpayer must be

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1. "The term 'Secretary' means the Secretary of the Treasury or his delegate." I.R.C. § 7701(a)(11)(B) (1976). "The term 'or his delegate' when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context. . . ." *Id.* § 7701(a)(12)(A).

2. I.R.C. § 6001 authorizes the Secretary to prescribe rules and regulations requiring every person liable for tax to keep records, render statements, and make returns. *See also* 26 C.F.R. §§ 1.6001-1 to 1.6011-1 (1982).

3. I.R.C. § 7602(a) (1976).

4. United States v. LaSalle Nat'l Bank, 437 U.S. 298, 310 (1978).

5. The definition of a "third-party recordkeeper" is found in I.R.C. § 7609(a)(3) (1976) (amended 1982).

given notice of the summons.[6] The taxpayer has the right to intervene in any summons enforcement proceeding, as well as the right to stay compliance with the summons by giving written notice to the person summoned not to comply with the summons.[7] The growth of the Service's use of these summonses, and the increasing number of taxpayers refusing to produce requested material or ordering third-party recordkeepers to stay compliance with such summonses[8] have compelled the courts to establish guidelines that strike a balance between the Service's right to obtain information under section 7602 and the taxpayer's individual rights.

One of the early Supreme Court cases in this area was *United States v. Powell*,[9] in which the Court rejected the taxpayer's contention that the IRS must show probable cause to suspect fraud before it could seek enforcement of a summons. The Court held instead that the Service must demonstrate that there is a legitimate purpose for the investigation, that the inquiry is relevant to the purpose, that the Commissioner does not already possess the information, and that he has followed all of the administrative steps required by the Code.[10] The Court then added a general prohibition against issuing a summons for any purpose that would reflect upon the "good faith" of the investigation.[11]

Later, in *Donaldson v. United States*,[12] the Court apparently laid down two separate standards, which resulted in confusion and inconsistency among the circuit courts. At one point in the opinion the Court ruled that where the sole purpose of the investigation is to gather evidence for a criminal prosecution, enforcement may properly be denied.[13] The Court's stated holding, however, was slightly different: "[A section 7602] summons may be issued in aid of an investigation if it is issued in good faith and prior to a recommendation for criminal prosecution."[14]

Seven years later, the Court was presented with an opportunity to settle this confusion. In *United States v. La Salle National Bank*,[15] the trial court found that the motivation of the IRS agent in conducting the investigation was solely to gather evidence for a criminal prosecution. The taxpayer then

6. I.R.C. § 7609(a)(1), (2) (1976) (amended 1982).

7. *Id.* § 7609(b). IRS summonses are not self-enforcing; rather, the Service must proceed under I.R.C. § 7604 to enforce a summons. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 331, 96 Stat. 324, 620-21 (to be codified at I.R.C. § 7609(b)(2)(A)), also grants the taxpayer the right to commence a proceeding to quash such a summons.

8. Nuzum, LaSalle National Bank *and the Judicial Defenses to the Enforcement of an Administrative Summons*, 32 TAX LAW. 383, 384 (1979).

9. 379 U.S. 48 (1964). *See also* Reisman v. Caplin, 375 U.S. 440 (1964) (IRS summons may be challenged on any appropriate ground, including defense that the material is sought for use in a criminal prosecution).

10. 379 U.S. at 57-58.

11. [A] court may not permit its process to be abused. Such an abuse would take place if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute or for any other purpose reflecting on the good faith of the particular investigation.

Id. at 58.

12. 400 U.S. 517 (1971).

13. *Id.* at 533.

14. *Id.* at 536.

15. 437 U.S. 298 (1978).

argued, and the trial court agreed, that he was not required to prove the absence of a civil purpose for the summons.

The Court rejected this argument and reaffirmed its adoption of the *Powell* elements of a good faith exercise of the summons authority.[16] The Court summarized the several requirements for enforcement. The summons must be issued before the Service recommends criminal prosecution to the Justice Department, and the Service must at all times exercise the summons authority in good faith.[17] This second prerequisite, according to the Court, incorporated the *Powell* standards of good faith and included the further requirement that the Service not abandon the pursuit of court tax determination or collection.[18] Whether the Service has abandoned its civil investigation depends upon the institutional posture of the IRS and not the objective of the individual agent.[19] The Court offered two examples of institutional bad faith: 1) delay by the Service in recommending a criminal investigation to the Justice Department once the institutional commitment for the referral has been made; and 2) action by the Service as an information-gathering agency for other departments.[20]

B. *Some Questions Answered, Some Remain Unsettled*

Powell, *Donaldson*, and *LaSalle* supply the backdrop for three major Tenth Circuit opinions addressed to IRS summons enforcement proceedings. In the first of the three cases, *United States v. Security Bank and Trust Co.*,[21] the court was called upon to rule on the extent to which discovery by a taxpayer would be permitted when he or she asserted the defense that the Service was pursuing a purely criminal investigation into his tax affairs. In *Security Bank*, the Service had issued a summons to the bank pursuant to its investigation of the income tax liability of Virgil Fox. At Fox's request the bank refused to comply with the summons. The Service petitioned the district court for enforcement of the summons, and Fox intervened as authorized by section 7609(b)(1).[22] Prior to the enforcement proceeding, Fox served eighteen interrogatories on the IRS agent who had issued the summons, but the agent objected to all but one as being irrelevant.[23] At the enforcement hearing, Fox filed a motion for an order to compel answers to the interrogatories. The trial court denied the motion, instead directing Fox to propound the interrogatories to the agent who was present at the hearing. The agent answered some of the questions but objected to several others, and the court sustained the objections.[24] After the court ordered enforcement of the summons, Fox appealed the trial court's rulings on the objections.

16. *Id.* at 313-14.
17. *Id.* at 318.
18. *Id.*
19. *Id.* at 316.
20. *Id.* at 316-17.
21. 661 F.2d 847 (10th Cir. 1981).
22. I.R.C. § 7609(b)(1) (1976).
23. 661 F.2d at 849.
24. *Id.* The interrogatories in question read as follows:

9. State whether or not the Internal Revenue Service has ever had [appellant] under surveillance either by wire or any other means.

The court of appeals reasoned that since the Supreme Court in *LaSalle* placed the burden of disproving a valid civil purpose for the investigation upon the party opposing enforcement of the summons[25] "the *LaSalle* Court must have envisioned at least limited discovery."[26] This is necessarily so because a taxpayer asserting the defense of improper purpose must rely on information within the knowledge of the Service.[27] Although most of the circuits have recognized the taxpayer's right to discovery, the proof required to obtain discovery, as well as the extent of discovery permitted, varies among the circuits. The Tenth Circuit has adopted the relatively restrictive position that discovery is available only in "extraordinary situations."[28]

Fox had objected to enforcement solely on the ground that the IRS was pursuing a purely criminal investigation. The court of appeals, following the guidelines set down in *LaSalle*, directed its inquiry to whether the interrogatories might yield information suggesting the IRS was not actively engaged in a civil investigation and found Interrogatories Nine through Twelve wholly irrelevant to this issue.[29] The court also observed that, although part (c) of Interrogatory Thirteen could be relevant in determining whether the IRS was investigating possible criminal violations, "even if a *criminal* investigation is underway, the Service may use the summons power so long as it is still actively engaged in a *civil* investigation."[30] The court suggested that "the

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a) If [appellant] has been under surveillance, state when, where, how, at whose direction, and under what authority.

b) State whether [appellant] is currently under surveillance, at whose discretion, and under what authority.

10. State whether IRS received information from any law enforcement agency regarding [appellant], at any time prior to the commencement of this investigation.

a) If yes, state from whom and the substance of that information.

b) State the dates on which such information was received.

11. State whether IRS has received information from any law enforcement agency regarding [appellant] subsequent to the commencement of this investigation.

a) If yes, state from whom and the substance of that information.

b) State the dates on which such information was received.

12. State whether the Internal Revenue Service has sought information from any law enforcement agency regarding [appellant].

a) If yes, state to whom inquiries were made, the nature of the inquiries, and the substance of any information received by the IRS.

b) State the date on which such inquiries were made.

13. State whether or not any information or informants have been or are being used by the Internal Revenue Service in their investigation of [appellant].

a) If yes, state the identity of the informants.

b) State the substance of the information the informants have given you regarding the tax liability of [appellant].

c) State the substance of any information received from informants regarding any criminal tax violations by [appellant].

Id. at 851-52.

25. [T]hose imposing enforcement of a summons do bear the burden to disprove the actual existence of a valid civil tax determination for collection purpose by the Service. . . .

Without doubt, this burden is a heavy one. Because criminal and civil fraud liabilities are coterminous, the Service will rarely be found to have acted in bad faith by pursuing the former.

Id. at 851-52 (quoting *LaSalle*, 437 U.S. at 316).

26. 661 F.2d at 850.

27. *Id.*

28. United States v. Southern Tanks, Inc., 619 F.2d 54, 56 (10th Cir. 1980).

29. 661 F.2d at 852.

30. *Id.* (emphasis in original).

taxpayer could obtain more direct evidence whether there is an active civil investigation simply by asking the status of the civil investigation, whether and when an institutional posture of recommending criminal investigation was reached, and the dates the investigation was begun and summonses were issued."[31]

In dictum, the court of appeals briefly discussed one of the defenses not raised by the taxpayer, namely, the Service's functioning as an information-gathering agency for other government agencies. Because Interrogatories Ten through Thirteen inquired into the information that other government agencies had furnished the IRS, and not whether the IRS was providing information to other agencies, these interrogatories were also irrelevant to the establishment of that defense.[32]

Judge McKay, concurring in part and dissenting in part, argued that the real issue was the tension between the possibility that the taxpayer would use the discovery device as a means to delay the investigation and the possibility that the Service would abuse its civil information-gathering powers to further a criminal investigation.[33] On the possibility of delay, Judge McKay argued that the primary means of taxpayer delay had already been checked by confining discovery to the required summons enforcement hearing.[34] Judge McKay contended that the taxpayer's interest should be recognized by allowing the taxpayer to present evidence of the times and frequency of contacts between civil IRS agents and those agents who conduct criminal investigations. Such contacts raise "an implication of entanglement of purposes,"[35] which requires the trial court to determine whether it should make further inquiry.

The dissenting opinion ignores, however, that an "entanglement of purposes" is perfectly legitimate under the *LaSalle* rule. The Supreme Court in *LaSalle* recognized the "interrelated criminal/civil nature of a tax fraud inquiry,"[36] and thus ruled that in order to block the enforcement of a summons, the taxpayer must disprove the existence of a valid civil tax determination or collection purpose by the Service.[37]

One possible defense that the court of appeals did not discuss, and to which Interrogatory Nine[38] appears to have been relevant, was the Service's delay in referring the case to the Justice Department for criminal investigation once the Service had made the "institutional commitment" to do so. Delay in recommending criminal prosecution in order to gather additional information was one of the *LaSalle* Court's examples of institutional bad faith.[39] The *LaSalle* Court expressed concern that countenancing such a delay "would permit the Government to expand its criminal discovery

31. *Id.*
32. *Id.* at 853.
33. *Id.* at 854 (McKay, J., concurring in part and dissenting in part).
34. *Id.*
35. *Id.*
36. 437 U.S. at 314.
37. *Id.* at 316.
38. *See supra* note 24.
39. 437 U.S. at 317.

rights."[40] *LaSalle* does not seem to suggest, however, that a court must determine whether the Service has abandoned its civil investigation. The critical point that must be determined is the time at which there was an institutional commitment by the IRS to make a referral. Use of its compulsory process to gather any additional information after this point in time, regardless of a civil purpose, is impermissible.[41]

In the next summons enforcement case to be decided, *United States v. Scholbe*,[42] the Tenth Circuit Court of Appeals addressed two issues arising under the *LaSalle* standards: 1) whether the Service had recommended criminal prosecution to the Justice Department; 2) whether the Service was acting as an information-gathering agency for the Drug Enforcement Administration (DEA). The case contained an additional quirk in that both parties agreed the trial court had applied an incorrect legal standard, and the party prevailing at the trial court level asserted that the trial court had made incorrect findings of fact.

The IRS began investigating the taxpayers in early 1978 and was notified shortly thereafter by the DEA of the Department of Justice that some of the taxpayers were suspected of being "Class I" drug traffickers. Pursuant to its investigation, the IRS issued over twenty summonses to third-party recordkeepers, but the taxpayers intervened and stayed compliance with each of the summonses.[43] Later in 1978, the IRS agent in charge of the investigation recommended that the case be referred to the Department of Justice for a grand jury investigation. The Service, however, asked the Justice Department not to proceed with any summons enforcement actions until the Service decided whether it would recommend criminal prosecution for tax fraud to the Justice Department.[44] Shortly thereafter, the IRS agent rescinded his request for a grand jury investigation, and served the summons on a third-party recordkeeper that formed the basis for this case. After the taxpayers once again intervened, the Service commenced the enforcement proceeding.

Four evidentiary hearings were conducted by the trial court over the following year, and the district court judge found that the IRS had recommended to the Justice Department that the taxpayers be prosecuted for tax fraud.[45] Nonetheless, the district court granted enforcement of the sum-

40. *Id.*

41. Note, *The Institutional Bad Faith Defense to the Enforcement of IRS Summonses*, 80 COLUM. L. REV. 621, 629 (1980). *See also* Note, *Discovery in the IRS Summons Enforcement Proceeding: Less Certain than Death and Taxes*, 31 U. FLA. L. REV. 321, 332-33 (1979).

Congress enacted legislation in 1982 that prohibits the issuance of a summons under I.R.C. § 7602 or the commencement of a summons enforcement proceeding under § 7604 if a "Justice Department referral" is in effect with respect to the taxpayer. A "Justice Department referral" is in effect if the "Secretary" (*see supra* note 1) has recommended to the Attorney General a grand jury investigation or criminal prosecution of the taxpayer, or if a request for a "return" or "return information" (*see infra* note 53) is made by the Justice Department. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 333(a), 96 Stat. 324, 622-23 (to be codified at I.R.C. § 7602(c)).

42. 664 F.2d 1163 (10th Cir. 1981).

43. *Id.* at 1164.

44. *Id.*

45. *Id.*

mons, because of an inadvertent error appearing in a previous Tenth Circuit case.[46] The previous case was *United States v. MacKay*,[47] in which the court of appeals mistakenly referred to the recommendation "of" the Justice Department, rather than recommendation "to" the Justice Department as the legal ground for denying enforcement.[48] Since there was no recommendation "of" the Justice Department for criminal prosecution, the trial judge ordered the summons enforced. This was the legal error that both parties agreed the trial court had made. In response, the Service, which had prevailed at trial, urged that the trial court judge had also made incorrect findings of fact, namely, that the IRS had recommended criminal prosecution to the Justice Department.

Upon an independent review of the facts, the court of appeals agreed with the government and concluded that the trial judge's finding was clearly erroneous.[49] The trial judge had not made specific references to evidence from which it concluded that the IRS had recommended criminal prosecution. Nor could the court of appeals find any such evidence upon its independent review of the record.

The only evidence the court of appeals found that alluded to any such recommendation was the testimony of an attorney in the Miami IRS District Counsel's Office. This attorney gave hearsay evidence that he believed that the IRS agent in charge of the investigation asked either an Assistant United States Attorney or a Department of Justice Attorney, or both, whether a grand jury could be used. The attorney further testified that he believed that the Justice Department's response to the agent in charge was that it did not want the case because there was insufficient information to warrant use of a grand jury investigation. The agent in charge of the investigation, however, testified that he had never spoken with anyone outside the IRS.[50]

The testimony given by the attorney for the Miami District Counsel's Office might raise the spectre of bad faith on the part of the Service in delaying a recommendation for criminal prosecution, after commitment to refer has been reached, while gathering additional evidence for the prosecution. The court of appeals correctly concluded, however, that "even if the trial court believed that [the agent in charge of the investigation] asked the Department of Justice whether a grand jury could be summoned, this inquiry does not constitute an institutional recommendation for criminal prosecution or commitment to make that recommendation at a future date."[51] Thus, the *LaSalle* bad faith defense did not apply.

The trial court had also apparently concluded, and the court of appeals agreed, that the IRS had agreed to provide the DEA with information the IRS obtained during its tax investigation. Although the *LaSalle* "good-faith standard will not permit the IRS to become an information-gathering

46. *Id.* at 1164-65.
47. 608 F.2d 830 (10th Cir. 1979).
48. *Id.* at 833.
49. *Scholbe*, 664 F.2d at 1165.
50. *Id.* at 1166.
51. *Id.*

agency for other departments,"[52] section 6103 of the Internal Revenue Code permits the Service, under carefully prescribed conditions, to disclose to certain individuals or groups, a taxpayer's "return" or "return information."[53]

The court of appeals recognized a duty in *Scholbe* to attempt to "reconcile the right to disclose information under I.R.C. § 6103(i)(2) with the admonition in *LaSalle* that the IRS may not become an 'information-gathering agency for other departments.' "[54] Examining the institutional posture of the IRS, the court found nothing in the record suggesting that the IRS had abandoned its civil investigation or that it intended to violate the strict guidelines of section 6103. There was thus no reason to refuse enforcement of the summons.[55] The court specifically pointed out that information authorized to be shared under section 6103 included information that the Service might obtain by means of the summons process.[56]

The third major summons enforcement case reviewed by the court of appeals was *United States v. Silvestain*.[57] Silvestain was an accountant in whose office the taxpayer's records had been placed for convenience during a routine audit conducted by the IRS. The agent in charge of the audit examined these books and records, and, after approximately twenty hours of examination, concluded that there was a possibility that tax fraud was involved in the case.[58] The agent then referred the case to the Criminal Investigation Division of the Service. A special agent subsequently issued a summons to the accountant for the production of the books and records. The taxpayer intervened pursuant to section 7609(b)(2),[59] alleging that the information sought to be obtained by means of the summons was already within the possession of the IRS (a violation of the *Powell* good-faith standard).[60] The taxpayer also alleged the special agent was effectively conducting a "second examination" of the taxpayer's records, without providing notice of the necessity for such examination, in contravention of section

52. *Id.* at 1168 (quoting *LaSalle*, 437 U.S. at 317).

53. A "return" includes "any tax or information return, declaration of estimated tax, or claim for refund . . . including supporting schedules, attachments, or lists which are supplemental to, or part of, the return." I.R.C. § 6103(b)(1) (1976). "Return information" includes "a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments." *Id.* § 6103(b)(2)(A) (1976). Under this section, the Service is authorized to disclose returns or return information to state tax officials, state audit agencies, persons having a material interest, congressional committees, the President, certain federal officials for purposes of tax administration (including officials of the Department of Justice), and certain federal officers or employees for non-tax criminal investigations. *Id.* § 6103(d)-(i) (1976 & Supp. IV 1980) (amended 1982).

54. 664 F.2d at 1167. The court's duty is consistent with the congressional intent behind I.R.C. § 6103, contained in JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 315, *reprinted in* 1976-3 C.B. 1, 327: "[T]he Congress strove to balance the particular office or agency's need for the information involved with the citizen's right to privacy and the related impact of the disclosure upon the continuation of compliance with our country's voluntary tax assessment system."

55. 664 F.2d at 1168.

56. *Id.* at 1167.

57. 668 F.2d 1161 (10th Cir. 1982).

58. *Id.* at 1162.

59. I.R.C. § 7609(b)(2) (1976) (amended 1982).

60. United States v. Powell, 379 U.S. 48, 58 (1964).

7605(b).[61] In defense, the taxpayer also asserted his fifth amendment privilege, claiming that the accountant was merely a conduit for him and that he still maintained possession of the records.

The court of appeals rejected the taxpayer's contention that the information sought by means of the summons was already in the possession of the Service because of the initial investigation. Since a tax fraud audit differs both quantitatively and qualitatively from a routine audit, the government could not be deemed already to possess the information sought.[62] The taxpayer also asserted that the administrative steps required by the Code in section 7605(b) were not followed by the Service. The court of appeals also rejected this argument, citing authority from other circuits holding that notification to the taxpayer is not necessary where the second inspection is, as a practical matter, merely a continuation of the original investigation.[63] Since the revenue agent had not completed her audit at the time she referred the case, the investigation by the special agent was merely a continuation of the original investigation. No notification to the taxpayer was necessary, because a second examination had not begun.

The court of appeals also denied the taxpayer's fifth amendment claim by rejecting the contention that he retained constructive possession of the records. The United States Supreme Court established the limits of the fifth amendment privilege in two cases in which tax records sought by the government were in possession of third persons. In the first of these cases, *Couch v. United States*,[64] the taxpayer was the sole proprietress of a restaurant. For several years she had given statements and records to her accountant for the purpose of preparing her income tax returns. In holding the privilege unavailable, the Court pointed out that the fifth amendment privilege is a personal one that attaches to the individual and not to the information sought.[65] The Court concluded that the privilege should be tied to the concept of possession of the evidence rather than ownership of it. The Court did leave open the possibility that in some situations constructive possession might be "so clear" or the relinquishment of possession by the owner of the record might be "so temporary and insignificant" that the fifth amendment privilege would still be available.[66] In *Fisher v. United States*,[67] after an investigation had begun into the possibility of civil or criminal violations by the taxpayers, the taxpayers transferred certain records from their accountants to their attorneys. When summonses were served on the attorneys, the attorneys invoked a fifth amendment privilege on behalf of their clients. The Court, relying on *Couch*, concluded that the *Fisher* situation was not a case of

61. I.R.C. § 7605(b) (1976) provides: "No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

62. 668 F.2d at 1163.

63. *Id.* at 1163-64.

64. 409 U.S. 322 (1973).

65. *Id.* at 328.

66. *Id.* at 333.

67. 425 U.S. 391 (1976).

constructive possession or merely temporary and insignificant relinquishment of possession.

The Tenth Circuit Court of Appeals interpreted constructive possession under *Fisher* and *Couch* to mean that "the records sought remain within the actual physical control of the party asserting the constitutional privilege even though they may be placed with another party for custodial safekeeping."[68] In *Silvestain*, the accountant was not given the records merely for custodial safekeeping. Hence, the court ruled enforcement of the summons would not violate the taxpayer's fifth amendment privilege.[69]

II. Employee Profit Sharing Plans

In *Tamko Asphalt Products, Inc. v. Commissioner*,[70] the court of appeals reviewed a United States Tax Court decision upholding the Service's ruling that Tamko's profit sharing trust did not meet the qualifications for tax benefits under section 401 of the Code.

A profit sharing plan such as the one drawn up by Tamko is a type of deferred compensation plan with tax benefits to both the employee and the employer. In general, the amounts contributed to the trust by the employer are deductible by the employer in the year the contributions are made,[71] as if the compensation were paid directly to the employee in the same year. The employee, however, pays no income tax on these contributions until he or she receives retirement benefits from the fund.[72] Furthermore, the income earned by a qualified trust is not taxable until it is distributed to the employee.[73]

In order to qualify for this special tax treatment, such a profit sharing trust must meet several requirements, including minimum vesting requirements[74] and a requirement that contributions or benefits do not discriminate in favor of employees who are officers, shareholders, or highly compensated.[75]

Several vesting alternatives that meet the minimum requirements are given in section 411 of the Code, and compliance with any one of these alternatives automatically satisfies the antidiscrimination provisions of section 401(a)(4), unless there is reason to believe that accrual of benefits or forfeitures will tend to discriminate in favor of key employees.[76] The Service has provided further guidelines for vesting and antidiscrimination. A plan under which an employee has a nonforfeitable (*i.e.*, vested) right to forty percent of his or her accrued benefits derived from employer contributions after four years of service automatically meets the nondiscrimination requirements of section 401(a)(4) ('4-40 vesting'). A plan that does not qualify

68. *Silvestain*, 668 F.2d at 1164.
69. *Id.* at 1165.
70. 658 F.2d 735 (10th Cir. 1981).
71. I.R.C. § 404 (1976 & Supp. IV 1980) (amended 1982).
72. *Id.* §§ 402(a), 501(a) (West Supp. 1982) (amended 1982).
73. *Id.* § 401 (West Supp. 1982) (amended 1982).
74. *Id.* §§ 401(a)(7), 411 (1976 & Supp. IV 1980).
75. *Id.* § 401(a)(4) (Supp. IV 1980).
76. *Id.* § 411(d)(1)(B) (1976).

for the 4-40 safe harbor must meet the "key employee test" or the "turnover test."[77] The "key employee test" is applicable only during the first seven years of an employer's existence, and was therefore irrelevant to Tamko's situation. Under the "turnover test," a plan would meet the nondiscrimination requirements of section 401(a)(4) if the turnover rate for rank and file employees during the last five years did not exceed the greater of six percent or the turnover rate of the prohibited group.[78]

The plan submitted by Tamko called for vesting of an employee's rights to twenty-five percent of the employer's contributions after five years of service, and thus did not qualify for the antidiscrimination safe harbor provided by 4-40 vesting. If an employee were terminated prior to full vesting (15 years), the unvested portion of his account would be distributed among the remaining participants in the plan. The data submitted by Tamko showed that the turnover rate of rank and file employees during the past five years was sixteen percent, while the turnover rate for the prohibited group was zero. (Only one officer was covered by the plan, and this officer had been continuously employed by Tamko for over fifteen years).[79]

Based on these facts, the Service concluded that the plan submitted by Tamko did not qualify under section 401 of the Code.[80] This determination was upheld by the Tax Court, and Tamko sought review by the Tenth Circuit Court of Appeals. On appeal, Tamko objected to the Tax Court's inclusion of the turnover rates of rank and file employees employed by Tamko's parent corporation and another subsidiary. The court of appeals noted, however, that the plan provided that employees who transferred between Tamko and its parent or the other subsidiary retained their previous years of service for vesting purposes, and that such transfers did not amount to termination. It was proper, therefore, in determining whether Tamko's plan was qualified, to consider the turnover rate of the affiliated corporations, since employees of the affiliated corporations could benefit from forfeitures under the Tamko plan.[81] Thus, the Tax Court decision was affirmed.

III. Basis of Partner's Partnership Interest

In *Long v. Commissioner*,[82] the Tenth Circuit Court of Appeals considered the taxpayer's calculation of the basis of an interest in a partnership formerly held by the taxpayer's father's estate. The taxpayer's father and brother formed a partnership to do business as the Long Construction Co., with the taxpayer's brother owning a seventy-five percent interest and his father a twenty-five percent interest.[83] Upon the father's death in 1963, the partnership was insolvent. Liabilities outstanding against the partnership included

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77. *See* Rev. Proc. 76-11, 1976-1 C.B. 550; Rev. Proc. 75-49, 1975-2 C.B. 584.
78. Rev. Proc. 75-49, 1975-2 C.B. 584, 585.
79. Tamko Asphalt Prods., Inc. v. Commissioner, 658 F.2d 735, 736-37 (10th Cir. 1981).
80. *Id.* at 738.
81. *Id.* at 740-41.
82. 660 F.2d 416 (10th Cir. 1981).
83. *Id.* at 417. The taxpayer had been a partner for six years, but he withdrew from the partnership in 1958. Long v. Commissioner, 71 T.C. 1, 2 (1978), *supplemental opinion*, 71 T.C. 724 (1979), *modified*, 660 F.2d 416 (10th Cir. 1981).

two contingent liabilities in the form of lawsuits and two debts owed to separate banks in the area. The lawsuits were later settled, the estate paying the entire amount of the settlement, including attorneys' fees. The estate also paid the entire amount due on the notes executed in favor of the banks.[84] The father had died testate, leaving his wife, the taxpayer, and the taxpayer's brother each one-third of his estate. In addition, the estate succeeded to the decedent's interest in the partnership.[85]

Although the estate paid these claims, the administrator sought and obtained an order of the probate court that the taxpayer's brother was liable as a general partner for seventy-five percent of all partnership liabilities. Since the brother had no assets with which to satisfy these liabilities, the probate court offset this debt against the brother's distributive share of the estate, thus leaving nothing for the brother under the will.[86] Six years later the partnership was liquidated, and the estate, in calculating its basis in its partnership interest, included the entire amount of the obligations previously paid by the estate. It thus ended up with a long-term capital loss from the partnership liquidation, which it was unable to use. The taxpayer, acting pursuant to section 642(h) of the Code, then claimed his share (now fifty percent, due to the probate court order) of the capital loss as a beneficiary of the estate. The IRS disallowed the loss claimed by the taxpayer, asserting that the estate had miscalculated its basis in its partnership interest.

Section 1014 of the Code provides that the basis of a partnership interest acquired from a decedent is equal to the fair market value of the interest at death.[87] This basis is increased by the estate's share of partnership liabilities[88] and by its distributive share of partnership income.[89] This basis is then decreased by the estate's share of partnership losses.[90] Finally, any liabilities assumed by the estate that result in an increase in the estate's share of partnership liabilities or in the estate's individual liabilities are treated as a contribution of money by the estate to the partnership.[91] In the instant case, all parties agreed that the fair market value of the partnership interest at the date of the father's death was zero; the adjustments due to the estate's distributive share of partnership income and losses were also not disputed. The dispute was over the estate's increase in its basis of 100% of the liabilities paid by the estate, even though the probate court had determined that the taxpayer's brother was liable to the estate for seventy-five percent of these payments.

The Tax Court agreed with the Commissioner, holding that the estate could increase the basis in its partnership interest only by an amount equal to twenty-five percent of the payment actually made by the estate.[92] The

84. 71 T.C. at 2, 3.
85. 660 F.2d at 417, 418.
86. *Id.* at 418.
87. I.R.C. § 1014(a) (Supp. IV 1980).
88. Treas. Reg. § 1.742-1 (1956).
89. I.R.C. § 705(a)(1) (1976).
90. *Id.* § 705(a)(2).
91. *Id.* § 752(a).
92. 71 T.C. at 10.

Tax Court stated that the record was unclear as to the amount that the estate was able to obtain from the taxpayer's brother and simply concluded that "the estate did receive [the brother's] full contribution."[93] Under section 752, the Tax Court thus increased the estate's basis by twenty-five percent of the partnership liabilities, the share actually assumed individually by the estate.[94] With an increase in basis equal only to twenty-five percent, instead of 100% of the partnership liabilities, the Tax Court concluded that there was a net capital gain to the estate upon liquidation of the partnership. The taxpayer, therefore, could not claim a capital loss under section 642(h).

The court of appeals agreed with the Tax Court's analysis, except for the Tax Court's conclusion that the record was unclear as to how much the estate was able to collect from the brother.[95] The appellate court, relying on state law, noted that when a distributee is indebted to the estate, the administrator may offset the debt against any property to which such indebted distributee is entitled.[96] The court further noted that was exactly what was done by the probate court in this case. After the offset nothing was left for the brother, and the probate court ordered the administrator to distribute the entire residue of the estate equally between the taxpayer and the father's wife.[97] From these facts, the court of appeals concluded that the estate had collected from the indebted son an amount exactly equal to his distributive share, namely, one-third of the net estate.[98] Thus, while the estate could increase its basis in the partnership by the entire amount of the brother's partnership liabilities assumed by the estate, the basis, in turn, had to be reduced by the amount deemed collected from the brother. These calculations gave the estate a net long term capital loss, and the case was remanded to the Tax Court for proceedings consistent with the calculations.

IV. SECTION 337 LIQUIDATIONS

Congress enacted section 337 to allow corporations (primarily closely held corporations) to liquidate all of their assets tax free, without having to worry about the trap laid by the Supreme Court in *Commissioner v. Court Holding Co.*,[99] and *United States v. Cumberland Public Service Co.*[100] In *Court Holding Co.*, negotiations for the sale of an apartment building took place between the corporate owner of the building and the prospective purchaser. After an oral agreement was reached and the prospective purchasers had paid $1,000 to the corporation, the parties met to reduce the agreement to writing. The corporation's tax attorney halted the transactions when he realized that the sale would result in a large tax liability to the corporation. It would have been far more advantageous for the corporation's shareholders (husband and

93. *Id.*
94. *Id.*
95. 660 F.2d at 418.
96. *See, e.g.*, Thompson v. McCune, 333 Mo. 758, 63 S.W.2d 41 (1933); MO. REV. STAT. § 473.630 (1978).
97. 660 F.2d at 418.
98. *Id.* at 420.
99. 324 U.S. 331 (1945).
100. 338 U.S. 451 (1950). For discussion of the history of § 337, see Central Tablet Mfg. Co. v. United States, 417 U.S. 673, 677-83 (1974).

wife) first to liquidate the corporation's assets, which consisted only of the apartment building, by having the corporation deed the building to the husband and wife in exchange for the surrender of their shares, and then to have the husband and wife sell the property to the purchasers.[101]

This is precisely what was done; however, the Tax Court concluded that despite these formalities the corporation had not abandoned the sales negotiations. Thus, the gain from the sale was attributed to the corporation. The Supreme Court agreed, holding that "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."[102]

Five years later, in *Cumberland Public Service Co.*, the Supreme Court upheld this procedure as a means to avoid corporate tax on the sale, distinguishing *Court Holding Co.* on its facts. Since the sale in *Cumberland* was negotiated by the stockholders rather than by the corporation, the shareholders were not deemed to be a mere conduit for a sale by the corporation.[103]

Section 337, the "anti-*Court Holding Co.* provision," was enacted to permit the liquidation and sale by a corporation of its assets without the necessity for *Cumberland*-type machinations undertaken in the hope that courts would continue to exalt the form over the substance. Section 337(a) provides that if a corporation adopts a plan of complete liquidation and distributes all of its assets (less those retained to meet claims) in a complete liquidation within twelve months after the adoption of such plan, the corporation shall not recognize gain or loss from the sale or exchange of property within the twelve-month period. The tax consequences to the shareholders will be identical whether the corporation sells the assets and then distributes the proceeds in liquidation, or distributes the assets in kind to the shareholders who then sell the assets. The term "property" is not defined for purposes of subsection (a); however, subsection 337(b)(1) excludes from the definition of "property" the following: (A) stock in trade and inventory; (B) installment obligations acquired in the sale of stock in trade or inventory; and (C) installment obligations acquired in respect of property, other than stock in trade or inventory, sold or exchanged before the date of adoption of the plan of liquidation.[104] Notwithstanding these exclusions, these items are included within the definition of "property" if "substantially all" of such property is sold or exchanged to one person in one transaction.[105]

In *Bear v. Commissioner*,[106] the court of appeals was faced with deciding whether the corporation had sold or exchanged substantially all of its property to one person in one transaction. In 1972, the corporation, Brookridge Development Company, Inc., adopted a plan of liquidation pursuant to which it entered into an agreement with Pacesetter Homes Co. The agree-

101. Court Holding Co. v. Commissioner, 2 T.C. 531, 532-36 (1943), *rev'd*, 143 F.2d 823 (5th Cir. 1944), *rev'd*, 324 U.S. 331 (1945).
102. 324 U.S. at 334.
103. 338 U.S. at 455.
104. I.R.C. § 337(b)(1) (1976)
105. *Id.* § 337(b)(2).
106. 650 F.2d 1167 (10th Cir. 1981).

ment called for Pacesetter to purchase from Brookridge thirty-eight real estate lots, the entire inventory of Brookridge's property. The contract recited a single price for the purchase of all thirty-eight lots, but it also contained a schedule of payment for the lots.[107] Deeds were to be delivered at the time of payment in full for each lot, and Pacesetter was entitled to select lots individually as it progressed through its development project. Pacesetter was not required to pay interest on the purchase price. The final lots were not conveyed until nearly two years after the adoption of the plan of liquidation.[108]

The court of appeals agreed with the Tax Court that the contract did not call for a completed sale within the meaning of section 337.[109] As to when a sale is completed, the court ruled that this question is essentially one of fact. Among factors to be considered are the transfer of legal title and the shift in the benefits and burdens of the property.[110] In *Bear* the transfer of legal title, the proration of taxes, and the shift in benefits and burdens with respect to each lot occurred upon payment for that lot.[111] The court held these sales could not qualify as a disposition in one transaction to one purchaser completed within twelve months of the adoption of the plan of liquidation; consequently, the nonrecognition provisions of section 337 were unavailable.[112]

In another section 337 case, *Liberty National Bank and Trust Co. v. Commissioner*,[113] the Tenth Circuit Court of Appeals dealt with the installment obligation provision of section 337(b)(1)(B). In this case the corporation, as part of its liquidation scheme, had sold its accounts receivable for $50,000 less than their book value. The corporation claimed that the loss was recognizable, arguing that accounts receivable are a type of installment obligation under section 337(b)(1)(B) and are thus specifically excluded from the nonrecognition provisions of the statute. The government, on the other hand, claimed that the definition of "installment obligation" should be limited to the terms in section 453 of the Code.[114]

The court agreed with the taxpayer, ruling that section 453 merely provides a means by which a taxpayer who regularly sells or disposes of property on an installment basis may report the income from such sales.[115] Judge McWilliams, writing for the majority, found authority in *Coast Coil Co. v. Commissioner*[116] and *Family Record Plan, Inc. v. Commissioner*.[117] In *Coast Coil*, the Tax Court adopted the view, and the Ninth Circuit agreed, that the term "installment obligations" under section 337(b)(1)(B) is broader than

107. *Id.* at 1169.
108. *Id.*
109. *Id.*
110. *Id.* at 1170.
111. *Id.*
112. *Id.*
113. 650 F.2d 1174 (10th Cir. 1981).
114. *Id.* at 1176-77.
115. *Id.* at 1177 n.4.
116. 50 T.C. 528 (1968), *aff'd*, 422 F.2d 402 (9th Cir. 1970).
117. 36 T.C. 305 (1961), *aff'd on other grounds*, 309 F.2d 208 (9th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963).

that envisioned by section 453. In *Family Record Plan* the accounts receivable were sold at a gain. The Tax Court upheld the Commissioner's position that the gain was taxable on the ground that the accounts receivable were installment obligations.[118]

V. CAPITAL VERSUS ORDINARY LOSS—COMMODITY FUTURES TRANSACTIONS

In *Oringderff v. Commissioner*,[119] the court of appeals reviewed the Tax Court's upholding of a deficiency assessment in connection with a taxpayer's losses incurred in the cattle feeding business. The taxpayer had treated losses arising from transactions in cattle futures as ordinary losses; however, the Commission successfully argued that the losses should be treated as capital losses.

Section 1221 of the Code contains a broad general definition of "capital assets" and a few explicit exceptions from the defintion.[120] The rule for treatment of gains and losses arising from transactions in commodity futures was established in *Corn Products Refining Co. v. Commissioner*,[121] wherein the taxpayer was a manufacturer of products made from corn. In order to avoid having to pay increased prices for corn brought on by shortages, the company began purchasing corn futures at harvest time when the price appeared favorable.[122] If no shortages were likely, it would take delivery on contracts only as required to supply its manufacturing process and would sell the remainder. If, on the other hand, shortages in the corn supply arose, the company would sell futures covering only the amount of corn that it was able to purchase on the spot market. The company treated the profits and losses arising from transactions in the futures as capital in nature, arguing that its futures trading was a separate business from its manufacturing operation and that it was acting as a "legitimate capitalist."[123] The Tax Court found, however, that the transactions constituted an integral part of its manufacturing business,[124] and that the profits and losses were thus ordinary in nature. The Supreme Court refused to overturn these findings of fact, noting instead that "it appears that the transactions were vitally important to the company's business as a form of insurance against increases in the price of raw corn."[125]

In *Oringderff*, the Tax Court found that many of the futures transactions were opened and closed on the same day, a clear indication of a substantial investment or speculative motive.[126] Furthermore, although the period for

118. *Family Record Plan*, 36 T.C. at 310-11. In *Liberty Nat'l Bank* the Service urged the court of appeals to adopt the opinion of Judge Ely, dissenting in *Coast Coil*. The court rejected this invitation. 650 F.2d at 1177 n.5.

119. No. 79-1703 (10th Cir. Aug. 10, 1981).

120. Excluded are inventory-type property, depreciable property, and certain types of intellectual property.

121. 350 U.S. 46 (1955).

122. *Id*. at 48.

123. *Id*. at 49.

124. *Id*. at 50.

125. *Id*.

126. No. 79-1703, slip op. at 2.

fattening cattle is between 120 and 150 days, the majority of the contracts were closed within ten days. From this, as well as the lack of correlation between the taxpayer's cattle purchases and sales and his futures transactions, the Tax Court found that the futures transactions were not "true hedges."[127] The court of appeals upheld the Tax Court's factual finding that the futures transactions were primarily speculative in nature, and not an integral part of the taxpayer's cattle business.[128] Thus, the gains and losses should have been treated as capital rather than ordinary.

VI. Dismissal Under Tax Court Rule 123(b)

In *Drury v. Commissioner*[129] the taxpayer appealed the Tax Court's order of dismissal under Rule 123(b) of the Tax Court Rules of Practice and Procedure for failure to prosecute his petition for review of deficiencies. Rule 123(b) provides that the Tax Court may dismiss a case and enter a decision against the petitioner for failure to prosecute properly his or her petition. Such a decision "shall operate as an adjudication on the merits."[130] The taxpayer's appeal of the 123(b) dismissal was based on his contention that the Tax Court had no jurisdiction over his case and was therefore without power to dismiss. The taxpayer claimed that the Tax Court was divested of jurisdiction because of his offer to withdraw his petition from the Tax Court. The Tax Court had treated this offer as a motion to withdraw, and had denied the motion. Apparently the taxpayer desired to commence an action for refund in federal district court.

The court of appeals viewed the taxpayer's jurisdictional argument as an attempt to circumvent the effects of section 6512(a),[131] which provides for an election of remedies by a taxpayer who has been served with a notice of deficiency. Under section 6512(a), once a petition for review of deficiencies is filed with the Tax Court, no suit may be filed by the taxpayer for the recovery of any part of the tax except as to overpayments determined by the Tax Court, amounts collected in excess of tax liability computed by the Tax Court, and amounts collected after the period of limitation has expired.[132] The taxpayer in *Drury* fell into none of these exceptions. Thus, once he filed his petition, he was unable to withdraw the petition and file suit in district court. According to the court of appeals, the Tax Court was never divested of jurisdiction. Given that more than two years had elapsed between the notice of deficiency and the taxpayer's motion to withdraw, the court of appeals believed the Tax Court justifably saw the attempted withdrawal as a dilatory tactic. The Tax Court was therefore warranted in granting the Commissioner's Rule 123(b) motion to dismiss the case on the merits for

127. *Id.* at 3.

128. *Id.* at 3.

129. No. 81-1670 (10th Cir. Feb. 1, 1982).

130. T.C. R. Prac. and P. 123(d). Rule 123(b) is thus similar to Fed. R. Civ. P. 41(b).

131. No. 81-1670, slip op. at 4. *See* I.R.C. § 6512(a) (1976 & Supp. IV 1980) (amended 1982).

132. A fourth exception, overpayments attributable to partnership items, was added by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402(c)(8), 96 Stat. 324, 668 (to be codified at I.R.C. § 6512(a)(4)).

failure to prosecute.[133]

VII. Determination of Income

In *Joslin v. United States*,[134] the taxpayer was assessed a deficiency based on his method of valuing income under section 61(a)(1). The taxpayer was an attorney who provided legal services to his clients in exchange for payment in silver dollars.[135] The attorney's normal billing rate was, by his own characterization, fifty "one-dollar" Federal Reserve notes per hour.[136] In the situation under review, the attorney rendered twenty hours of legal services to his client and received 200 silver dollars as his fee. Although he could have billed the client for 1,000 "one-dollar" Federal Reserve notes rather than the 200 silver dollars, he reported only $200 as income from this transaction on his return.

The district court dismissed the attorney's suit to recover the deficiency assessment.[137] The court of appeals affirmed, essentially characterizing the silver dollars as "property" other than cash.[138] Under the Treasury Regulations,[139] such property is measured at its fair market value for income purposes. The taxpayer in effect had admitted that the silver dollars had a market value of five times their face value. The court ruled it inconsequential that silver dollars have a face value of one dollar and can be exchanged for a one dollar Federal Reserve note, pointing out that Congress has provided a means by which the Treasury Department can sell silver dollars at their fair market value, rather than at their face value.[140]

VIII. Availability of Deductions

The court of appeals reviewed three cases in which deductions taken by the taxpayer were disallowed by the Commission. In *Pilcher v. Commissioner*,[141] the taxpayer was employed as a pipefitter at a construction site located sixty-seven miles from his residence. There were no living quarters available at the construction site, and the taxpayer could find none closer than his place of residence. The taxpayer worked at the construction site for several months in 1970 or 1971, and again from late 1973 until early 1978. The taxpayer deducted the costs of commuting to and from the job site on his 1974 and 1975 income tax returns. These deductions were disallowed by

133. No. 81-1670, slip op. at 4-5.

134. 666 F.2d 1306 (10th Cir. 1981) (per curiam).

135. *Id.*

136. *Id.* at 1306-07.

137. The same argument was rejected by the Tenth Circuit in United States v. Ware, 608 F.2d 400 (10th Cir. 1979), a case in which Mr. Joslin represented the taxpayer. In that case, Mr. Joslin "stated that his concern was not with the defendant, his client. Such as it was, his concern was with obtaining a ruling which would nullify the use of Treasury notes as legal tender and which would compel such obligations to be paid in gold coin." *Id.* at 402.

138. 666 F.2d at 1307.

139. Treas. Reg. § 1.61-2(d)(1), T.D. 7554, 1978-2 C.B. 71, 73.

140. *See* Bank Holding Company Act Amendments of 1970, P.L. 91-607, § 205, 84 Stat. 1760, 1769 (authorizing sale by Secretary of the Treasury of approximately three million silver dollars).

141. 651 F.2d 717 (10th Cir. 1981) (per curiam).

the Commission, and the Tax Court upheld the disallowance.[142]

Section 162(a)(2) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . traveling expenses . . . while away from home in the pursuit of a trade or business." On the other hand, no deduction is allowed for personal, living, or family expenses.[143] In determining whether a deduction is available under section 162(a)(2), a key question that must be answered is whether the taxpayer is "away from home."[144] The Commissioner has ruled that a taxpayer's "home," for purposes of section 162(a)(2), is his regular or principal place of business or employment.[145] This concept of a section 162 "tax home" is not universally accepted by the courts, as the Second Circuit rejects this definition.[146] The next obstacle the taxpayer confronts is establishing that the assignment is only "temporary" in nature. The Tax Court has recognized a distinction between employment that is temporary and that which is merely indefinite.[147]

When the taxpayer in *Pilcher* resumed working in 1973 it was anticipated that construction on the project would continue for several additional years. Given this record, the Tenth Circuit Courts of Appeals concluded there was ample evidence to support the Tax Court's decision that the taxpayer's employment at the construction site was not temporary. Thus, the court affirmed the disallowance.

The court considered another case involving a deduction under section 162(a), this one supported by a claim that the deduction could also be made under section 212.[148] In *Snyder v. United States*[149] the taxpayer was a practicing attorney who began work on a book of photographs of Colorado in 1972. Pursuant to his expectation and goal of publishing the book, the taxpayer acquired sophisticated photographic equipment and devoted approximately thirty hours a week to the effort. The number of rolls of film that the taxpayer exposed increased dramatically from 1971 to 1972, and the taxpayer began to keep detailed records of technical data regarding his photographs. After corresponding with several publishers to promote interest in his book, the taxpayer traveled to New York and San Francisco to meet with some of them. Although almost all of the taxpayer's income was derived from practicing law, he claimed deductions for his photographic efforts on his 1972 and 1973 income tax returns. The IRS determined that the deductions were not allowable under either section 162 or section 212 and assessed the taxpayer accordingly. The taxpayer paid the amount assessed, filed a claim for

142. *Id.* at 718.

143. I.R.C. § 262 (1976).

144. *See, e.g.*, Commissioner v. Flowers, 326 U.S. 465, 470 (1946).

145. *See* Rev. Rul. 71-247, 1971-1 C.B. 54; Rev. Rul. 60-189, 1960-1 C.B. 60.

146. *See, e.g.*, Six v. United States, 450 F.2d 66 (2d Cir. 1971); Rosenspan v. United States, 438 F.2d 905 (2d Cir.) *cert. denied*, 404 U.S. 864 (1971).

147. *See, e.g.*, McCallister v. Commissioner, 70 T.C. 508 (1978); Blatnick v. Commissioner, 56 T.C. 1344 (1971); *cf.* Commissioner v. Flowers, 326 U.S. 465 (1946). *But see* Harvey v. Commissioner, 283 F.2d 491 (9th Cir. 1960) (rejecting the "temporary-indefinite" distinction).

148. I.R.C. § 212(a) (1976) allows a deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income."

149. 674 F.2d 1359 (10th Cir. 1982).

a refund, and instituted a suit to recover the assessments.[150]

The trial judge, in what he termed to be "rough" oral findings of fact and conclusions of law from the bench, found that the taxpayer had "sincere hopes" of selling his photography book and that he "does hope to make a profit."[151] Nonetheless, the judge concluded that the taxpayer was not engaged in the "trade or business" of publishing a book, and upheld the Commission's disallowance of the deductions under both sections 162 and 212.

The term "trade or business" is not defined in the Code, nor has a definitive answer appeared in the case law. The Supreme Court has stated that the determination whether the activities of a taxpayer amount to "carrying on a business" requires an examination of the facts in each case.[152] As the court of appeals in *Snyder* pointed out, lower courts have seized upon the profit motive as a major test in determining whether a taxpayer is engaged in a trade or business.[153] It is this element that generally distinguishes a trade or business from a mere hobby. Expenses incurred in the pursuit of hobbies are clearly not deductible under either section.[154] Relying on a Third Circuit case,[155] the court admonished the trial court on remand to sift through the facts carefully to determine whether the taxpayer was "primarily motivated . . . by his love of photography as a hobby or by a good faith expectation of making a profit."[156] Even if the taxpayer were primarily motivated by profit, he was also required to show that the activities were "extensive" and were carried on over a "substantial" period of time.[157]

The court directed that if the trial court were to find that the taxpayer was not engaged in a trade or business, it must then examine whether under section 212 the expenses were deductible as "ordinary and necessary . . . for the production or collection of income." As the court noted, sections 162 and 212 are to be read together, and in order to be deductible under section 212, the expense "must satisfy the same requirements that apply to a trade or business expense under section 162 except that the person claiming the deduction need not be in the trade or business."[158] The case was remanded for further factual findings and legal reasoning.

In *Kilgroe v. United States*,[159] the Tenth Circuit Court of Appeals considered depreciation deductions taken under section 167 of the Code.[160] The taxpayer in this case was the transferee of KIP Corporation, and as such was responsible for the prior tax liabilities of the corporation. In 1969, KIP Corporation had constructed some prefabricated buildings that were then leased

150. *Id.* at 1361-62.
151. *Id.* at 1362.
152. Higgins v. Commissioner, 312 U.S. 212, 217 (1941).
153. 674 F.2d at 1362.
154. *See, e.g.*, American Properties, Inc. v. Commissioner, 262 F.2d 150 (9th Cir. 1958); Wrightsman v. United States, 428 F.2d 1316 (Ct. Cl. 1970).
155. Imbesi v. Commissioner, 361 F.2d 640 (3d Cir. 1966).
156. *Snyder*, 674 F.2d at 1364.
157. *Id.*
158. *Id.* (quoting Fischer v. United States, 450 F.2d 218, 222 (7th Cir. 1973)).
159. 664 F.2d 1168 (10th Cir. 1981).
160. I.R.C. § 167(a) (1976) allows "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or of property held for the production of income."

to a community college for three years. For the years 1970 through 1974 the corporation took deductions under section 167 based on a three-year useful life of the buildings. The result of this rapid depreciation was that loss deductions were carried over into the taxpayer's 1973 tax return. The Service disallowed these deductions, claiming that the buildings had either a useful life of forty years, with no salvage value, or three years with a salvage value of $389,375. The buildings originally cost $578,030 to construct.[161]

The district court found that the buildings had a useful life of ten years with no salvage value, a finding that was not disputed by either party on appeal. The dispute was over the method of calculating the allowable depreciation for the remaining seven years of the buildings' useful lives. The taxpayer maintained that the deductions taken by KIP in the first three years were not allowed by the Internal Revenue Service and thus could not be counted when figuring the depreciation for the following years. The Service maintained that the depreciation for the first three years had not been challenged, and therefore was allowed under section 167. As a result, the government argued, the adjusted basis, for calculating the remaining depreciation, was the difference between the original basis and the amount already deducted (to the extent such deductions produced a tax benefit) during the first three years of the buildings' lives. The district court ruled for the taxpayer on this issue, and ordered a refund. On appeal, the government claimed that the district court had made an error in arriving at the amount of refund due the taxpayer, and the taxpayer apparently conceded that the government's position was correct.[162]

The court of appeals reversed the trial court's holdings, stating that the deductions taken during the first three years of the buildings' lives had not been challenged and were, therefore, "allowed" under section 167. The court noted that the district court's result, reducing the basis by only the amount that should have been deducted during the first three years, rather than by the amount actually taken, would violate the well-established rule that a taxpayer's total claimed depreciation deduction could not exceed the cost of the asset minus its salvage value.[163]

IX. CRIMINAL CONVICTIONS

In two noteworthy cases, the court of appeals reviewed criminal convictions, upholding both. In *United States v. Erickson*,[164] the taxpayers, husband and wife, owned and operated a tax service in Oklahoma. In addition to being charged with willfully aiding and abetting in the preparation of false income tax returns of their clients, the taxpayers were charged with willfully failing to file their income tax returns for three years. On appeal, the defendants contended that the affidavit supporting the issuance of a search warrant was insufficient due to the staleness of its contents. The court of appeals rejected this argument, noting that some of the incriminating infor-

161. 664 F.2d at 1169.
162. *Id.*
163. *Id.* at 1170.
164. 676 F.2d 408 (10th Cir.) *cert. denied*, 103 S. Ct. 118 (1982).

mation had been supplied by a current employee of the tax service.[165] Furthermore, the affidavit indicated that the violations were ongoing.

One of the other defenses, advanced by the husband, was that he lacked the ability to form a specific intent to commit the crime with which he was charged. An expert defense witness testified that the husband had "over the years developed a 'delusion' about the tax laws to the end that although Erickson could control his conduct, he nonetheless did not believe that he was doing anything wrong by disobeying the tax laws."[166] The trial judge accordingly instructed the jury that evidence concerning the husband's mental state could be considered only for the purpose of determining whether he had the requisite specific intent to violate the tax laws. The taxpayer apparently had wanted an instruction on the insanity defense, an instruction the trial court did not give. The court of appeals upheld the instruction given, since the expert testimony addressed merely the inability to form a specific intent.[167]

The trial court had also excluded evidence that the taxpayers in good faith believed that the tax laws were unconstitutional. Citing *United States v. Dillon*,[168] the court of appeals rejected this defense. An evil motive or bad purpose is not required to establish the offense.[169]

United States v. Lawson[170] was a tax protester case in which the defendant had filed blank income tax returns for 1978 and 1979, and had claimed ninety-nine exemptions on the withholding certificate he gave to his employer in 1979, thus claiming total exemption from withholding. On appeal, the court found most of Lawson's contentions specious.

Lawson claimed that the trial court erred in denying his pretrial motions to dismiss because his wages were not income within the meaning of the Internal Revenue Code and the Constitution. Lawson also claimed error in the trial court's refusal to hold his trial in Casper, Wyoming, rather than in Cheyenne, its refusal to exclude federal government employees from the jury panel, and its refusal to allow Lawson to inspect and copy jury selection records.[171] The court of appeals rejected the first three claims, but remanded the case to allow Lawson's counsel to inspect the jury selection records pursuant to 28 U.S.C. § 1867(f).[172] The court ruled that reversal of the conviction was not called for at that time; however, if, upon inspection of the jury selection records Lawson could prove an improper method of selecting the jury, the conviction would be set aside at that point.[173]

Lawson also asserted the trial court erred in denying his motions for acquittal at the end of the government's case and at the close of all evidence.

165. *Id.* at 410.
166. *Id.*
167. *Id.*
168. 566 F.2d 702 (10th Cir. 1977), *cert. denied*, 435 U.S. 971 (1978).
169. 676 F.2d at 411.
170. 670 F.2d 923 (10th Cir. 1982).
171. *Id.* at 925.
172. 28 U.S.C. § 1867(f) (1976) permits a party, in preparing a motion to dismiss for failure to comply with the statutory jury selection provisions, to inspect and copy records used by the jury commission or clerk in connection with the selection process.
173. 670 F.2d at 926.

These motions were based upon the failure of the government to establish jurisdiction, and his fifth amendment privilege against self-incrimination. Lawson also contended the government failed to prove willfulness in not filing returns and in claiming ninety-nine exemptions on the withholding certificate, or specific intent to deceive his employer upon claiming the ninety-nine exemptions. Lawson further claimed that the jury's verdict was against the weight of the evidence and thus could not stand. He also appealed his sentence and the probation conditions imposed by the trial judge. The court of appeals rejected all of Lawson's contentions.[174]

The sentencing and probation conditions imposed by the trial judge did raise some noteworthy points. As a condition of his probation, the trial court required that Lawson "disassociate himself with any organization that has [as] its purpose defeating the Internal Revenue Service laws, including an organization known as the Wyoming Patriots and shall not encourage other individuals to disobey the laws of the United States."[175] Lawson's appeal was based on the first amendment right of association. The court of appeals construed the condition so as to prohibit association only with groups that advocated violation of the tax laws and thus upheld the condition of probation.[176]

The court relied on two other tax protester cases, *United States v. Smith*[177] and *Porth v. Templar*.[178] In *Smith*, a condition of parole that the parolee "divorce [himself] from any organization advocating the willful disobediance of any local, state or federal law and . . . refrain from making any statement to others advocating any disobedience of any local, state or federal law,"[179] was modified by the court of appeals. The court struck the phrase "any local, state, or federal law" as too broad a restriction that was not reasonably related to the rehabilitation of the parolee. The court substituted the phrase "the Internal Revenue Code."[180] Similarly, in *Porth*, the probationer was prohibited from circulating materials questioning the constitutionality of the Federal Reserve System and the Federal Income Tax Law, from speaking or writing activities questioning the constitutionality of the same, and from leaving the jurisdiction of the court without prior written authorization. The court of appeals in *Porth* held that the conditions were invalid to the extent that they prohibited the expression of opinions as to invalidity or un-

174. *Id.* at 927-30.

175. *Id.* at 929.

176. *Id.* at 930. Trial courts have broad discretion in sentencing matters, including prescribing conditions of probation. *See, e.g.*, Malone v. United States, 502 F.2d 554 (9th Cir. 1974) (defendant convicted of unlawful exportation of firearms from the United States to the United Kingdom; conditions of probation included that he not participate in any American Irish Republican movement; that he belong to no Irish organizations, cultural or otherwise; that he not belong to or participate in any Irish Catholic organizations or groups; that he not visit any Irish pubs; and that he accept no employment that directly or indirectly associated him with any Irish organization or movement); United States v. Kohlberg, 472 F.2d 1189 (9th Cir. 1973) (defendant pleaded guilty to a charge of mailing obscene matter; condition of probation included that he not associate with any known homosexuals).

177. 618 F.2d 280 (5th Cir.), *cert. denied*, 449 U.S. 868 (1980).

178. 453 F.2d 330 (10th Cir. 1971).

179. 618 F.2d at 282.

180. *Id.*

constitutionality of the laws in question but were valid so far as they prohibited urging or encouraging others to violate the laws.[181]

The trial court had also sentenced Lawson to four months in prison for failing to file the 1978 return, assessed him the costs of prosecuting the case for failing to file the 1979 return, and fined him $2,000 for falsely filling out the withholding certificate. Sometime afterwards, but before Lawson had paid the fine or begun serving his sentence, the trial court realized that the fine for filing a false withholding certificate could not exceed $500.[182] The judge then modified the sentence by eliminating the fine for filing the false certificate but imposing a $2,000 fine for failing to file the 1979 return. On appeal, Lawson asserted that the judge could not increase his sentence once it had been imposed. The court of appeals, relying on *United States v. DiFrancesco*[183] also rejected this assertion.[184]

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181. 453 F.2d at 334.

182. 670 F.2d at 929. *See* I.R.C. § 7205 (West Supp. 1982) (amended 1982) (fine was increased to $1,000 maximum for tax years beginning after Dec. 31, 1981).

183. 449 U.S. 117 (1980).

184. 670 F.2d at 929.